Philip Angelides

Treasurer
State of California

May 2000

THE HONORABLE GRAY DAVIS
Governor

THE HONORABLE JOHN L. BURTON
President pro Tempore of the Senate

THE HONORABLE ROBERT M. HERTZBERG
Speaker of the Assembly

As Californians, we are fortunate to live in the most economically vibrant State in the richest nation on earth. These times of economic success represent an extraordinary opportunity to secure California's social and economic strength well into the 21st Century.

The widening disparity of economic opportunity across the State threatens our sustained success. There is a correlation between the breadth of economic opportunity and long-term economic progress. In the end, if communities are left to languish and if there is a large and growing underclass outside the mainstream of hope, future economic prospects will be dimmed.

As the State's chief investment officer, it is my obligation not only to be a prudent steward of our fiscal resources today, but also to look ahead and to take actions which will strengthen California's economy into the future.

Accordingly, the Office of the Treasurer is launching a new initiative — *The Double Bottom Line: Investing in California's Emerging Markets* — to mobilize the power of the capital markets for public purpose. This initiative must be part of a larger fabric of broad public policy efforts undertaken to close the chasm between the "two Californias."

I hope that you will join with me in carrying out the policies and programs of *The Double Bottom Line*. I look forward to working with public and private sector leaders across this State to create a new era of investment for California.

Sincerely,

PHILIP ANGELIDES
State Treasurer

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Executive Summary

We live in an extraordinary moment in California history. We are in the midst of a remarkable economic boom, which is helping shape a new global economy. The financial strength of our State is reflected in a wide array of indicators — from record low unemployment to record rises in personal income to dramatic increases in state revenues.

Yet, ours is a State that faces enormous challenges which, if unmet, will undermine our sustained economic progress in the 21st Century. Among the most serious of those challenges is the widening disparity in economic opportunity across the State — which threatens to create a future of "two Californias." Many Californians and many communities are not sharing in the benefits of these times of bounty.

California's economic and social strength will be diminished if the issue of inequality of economic opportunity goes unaddressed. It is a matter of great common interest to all Californians and all communities to close the widening economic chasm.

In light of this reality, this office released *Smart Investments*, in June of 1999, which articulated policies to direct State infrastructure investment in ways that meet California's future challenges. A key tenet of the report was that State infrastructure expenditures should be focused on the communities left in the wake of the State's surging economy. Since its release, the Treasurer's Office has moved forward to implement the policies of the report in a variety of State public financing programs.

As *Smart Investments* recognized, any serious public policy battle to close the gap between the "two Californias" must be waged across a broad front. The State must truly commit itself to a set of public investments — particularly in education and job skills training — which create the environment of economic hope. State and local governments must embrace public policies that enable increased private sector investment in California's struggling communities. And, the public sector must provide the resources for social services, childcare, and healthcare essential to community well-being, stability, and growth.

Any policy thrust to broaden economic opportunity must also examine how the assets and capital of the public *and* private sectors can be prudently invested in pursuit of that cause. After all, in our free enterprise system, investment capital plays a fundamentally important role in shaping our society.

The State of California — principally through its $300 billion plus pension and investment portfolios — is integrally woven into the fabric of the global capital markets. California's private sector investors lead the world in financial and economic innovation. This investment power comes with the responsibility to manage capital wisely. It also comes with the opportunity to affect the marketplace and, thus, to set a leadership example in a new movement of capital to economically struggling communities.

> The time has come to examine anew the confluence between the need for capital in California's emerging markets and the opportunities that exist for financially prudent investment in those markets.

It is, in this context, that the Treasurer's Office is pursuing a new initiative — *The Double Bottom Line: Investing in California's Emerging Markets* — to mobilize the powerful instrument of financial capital in new and innovative ways, consistent with the highest fiduciary standards, to respond to the challenges of widening economic disparity. This initiative calls on the public sector — from public pension plans to state and local governments — to invest capital in a way which meets "the double bottom line" — achieving successful investment results and broadening economic opportunity in California's at-risk communities. It calls on the private sector — the engine of our remarkable economy — to join the public realm in finding and making investments that can bring new life and vitality to the State's less prosperous neighborhoods.

The Double Bottom Line moves away from an old notion of community reinvestment as a secondary or lesser opportunity to a new understanding of the real risks and rewards of investing in the sectors and communities of California most in need of capital. It builds on a growing knowledge base about the opportunities for successful investment in communities historically overlooked by institutional capital sources. It comes at a time when old myths are being swept away by the facts and experience of successful reinvestment — from retailers profitably re-entering inner-city markets to lenders finding new opportunities in traditionally underserved communities. It is based on the proposition that thoughtful, prudent investments can achieve risk-adjusted, market returns *and* positive results for California communities.

The Double Bottom Line goes beyond the advocacy of policies. It creates a path for public and private sector capital by setting forth specific investment models which meet the test of fiduciary soundness and broader economic opportunity. These initiatives are a beginning — beachheads in what must be a wider war on economic inequality.

The model initiatives contained in *The Double Bottom Line* will direct over $8 billion in investment capital — through State programs and the State's pension and investment funds — to spur economic growth and development in California communities. This commitment of capital is more than a one-time infusion. Rather, it represents an investment pool which can be reinvested as transactions are completed and returns are realized. The initiatives also will leverage substantial, additional private investment in the sectors and communities most in need of capital for economic expansion. They are not meant to be all encompassing, but rather reflect initiatives the Treasurer's Office is pursuing to establish a new policy direction. Indeed, the policies of the *Double Bottom Line* need to be applied to a broad range of State programs, assets, and investments.

The model initiatives contained in The Double Bottom Line will direct over $8 billion in investment capital — through State programs and the State's pension and investment funds — to spur economic growth and development in California communities.

Over the past decade, billions of dollars of American capital have flowed to risky and highly volatile developing countries across the globe — the so-called overseas emerging markets. Indeed, the State's two largest pension funds have over $5 billion invested in these markets. Yet, at the same time, California's undercapitalized communities — our own emerging markets — have struggled to attract desperately needed capital investment to fuel their resurgence.

The time has come to examine anew the confluence between the need for capital in California's emerging markets and the opportunities that exist for financially prudent investment in these markets.

The Double Bottom Line is based on five policies, which it is hoped, will serve as the foundation for a new era of capital investment in California's future. Those policies are as follows:

- *Public Pension Funds and Investment Pools Can Lead the Way in a New Era of "Double Bottom Line" Investment — Achieving Successful Investment Results and Broadening Economic Opportunity.*
- *Public Pension Funds Must Broaden Their Pool of Investment Managers to Capitalize on California Emerging Market Opportunities.*
- *Public Financial Resources and Assets Should Leverage Capital Investment in Economically Struggling Communities.*
- *State Government — in Partnership with Local Governments, Educational Institutions, Foundations and the Private Sector — Should Spur Capital Investment in Historically Overlooked Communities by Funding Critically Needed Market Research.*
- *Private Sector and Foundation Capital Must Join in Partnership with the Public Sector in a New Commitment to Investing in California's Struggling Communities.*

There should be no doubt that the capital markets — including publicly and privately managed funds — can find ways to successfully invest in California's emerging markets if the commitment to do so is present. After all, in an economy in which American capital invests in vehicles as diverse as foreign emerging market stocks to securitized credit card portfolios, the capability certainly exists to find smart ways to channel investment to enrich California's social and economic fabric.

The road to a "double bottom line" investment policy for California will be long one, but it is a journey worth making. As Federal Reserve Chairman Alan Greenspan remarked earlier this year, "I have no illusion that the task of breaking down barriers that have produced disparities in income and wealth will be simple… Although we have achieved much in this regard, more remains to be done."

The full engagement of the public and private sectors in pursuing the policies of *The Double Bottom Line* holds out great possibilities. The *risks* of not pursuing new paths of investment policy will be an uncertain economic future, accompanied by economic and social divisions unlikely to produce good results. The *returns* of investing prudently to close the gap between the "two Californias" will be an economy of sustained strength and a social fabric bound together in common purpose. ■

The Double Bottom Line: Investing in California's Emerging Markets

A Tale of Two Californias

For California, these are the best of times and the worst of times.

We live in a time of unparalleled bounty — the most economically vibrant State in the richest nation on earth. Each week and each month bring new reports of prosperity: record low unemployment; strong job growth; and robust economic expansion. California's economy is being propelled by powerful and creative forces which are helping shape a new global economy.

The economic strength of our State is reflected in a variety of indicators. Forecasts estimate an increase of approximately 3 percent in the number of jobs this year. Personal income is expected to grow by over 6 percent this year and reach over $1.7 trillion within the next decade. And taxable sales are projected to rise by well over 5 percent by year's end.[1]

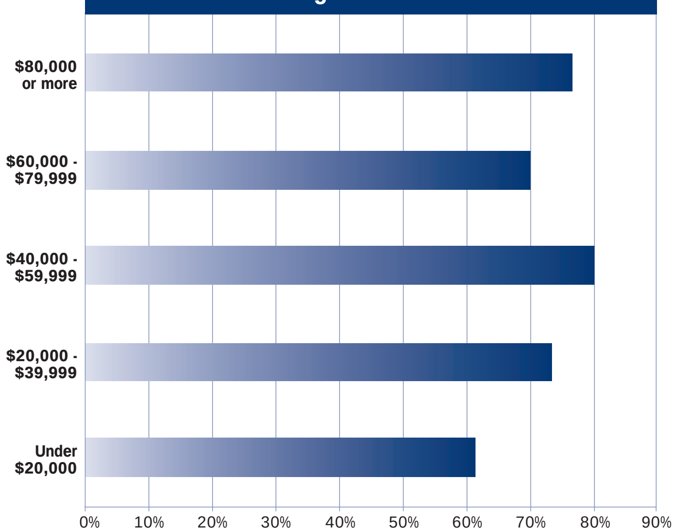
The economic good times are also reflected in the fiscal position of state government itself. Revenues to the State are up by billions of dollars beyond the levels forecast as recently as last June. And the assets of the State's pension funds grew by over $74 billion in 1998 and 1999, on the strength of the soaring national and state economies.[2]

This economic wave has been accompanied by an unprecedented creation of personal wealth. Indeed, 98 of the *Forbes 400* richest Americans now live in California.[3]

But that is not the whole story. In the midst of this remarkable economic boom, ours is the tale of "two Californias."

Despite all its successes, California has the greatest gap between rich and poor of all but four states and the gap widened during the last decade. The level of poverty, particularly among children, remains stubbornly high. In January of this year, the Center on Budget and Policy Priorities released a study which showed that, in the 1990s, the poorest 20 percent in California saw their real incomes drop by 10 percent — to just over $12,000 per year.[4] And, these economic challenges are not limited to the poorest Californians — as working families also struggle to hold their ground.

Californians (by Income Level) Expecting the Gap Between Rich and Poor to Grow, Looking Ahead to 2020



Source: Public Policy Institute of California Statewide Survey, December 1999

There are warning signs that economic disparities may widen further. A December 1999 survey conducted by the Public Policy Institute of California (PPIC) found a deep digital divide: households with incomes of greater than $80,000 per year are more than twice as likely to frequently use computers than those with incomes below $40,000 per year.[5]

Clearly, the benefits of the State's economic surge have not fully reached many California communities and families. The story of the Silicon Valley is not the story of the San Joaquin Valley (see page 28, *The Great Divide*).

Californians are not blind to this dichotomy. Indeed, it is a matter of anxiety and concern. The same 1999 PPIC survey found that 72 percent of all Californians expect the gap between rich and poor to widen in the years ahead. Of note is the fact that middle income Californians believe that in the greatest numbers — perhaps fearing that they might fall on the wrong side of the chasm.[6]

The issue of economic inequality has been with us through the ages. It is one of the most difficult and intractable problems that any society — even the most forward looking — faces. It defies easy solutions or silver bullets. It cannot be attacked on a single front, nor does it lend itself to rapid and politically gratifying resolution.

Yet, the failure, in and of itself, to address the issue poses great dangers. Aristotle saw poverty — the absence of a shared stake in society — as a great threat to democracy. Federal Reserve Chairman Alan Greenspan has cited economic inequality as a potential threat to the nation's security.[7]

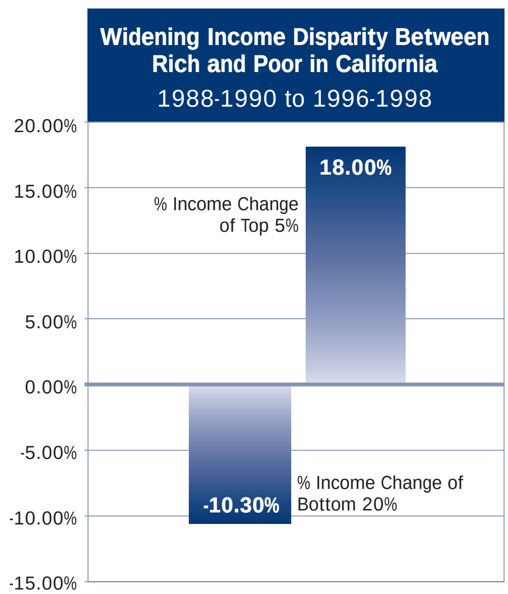
The very essence of the American and California dreams has been and remains equality of opportunity. "Nothing struck me more forcibly," said Alexis de Tocqueville speaking of America in 1831, "than the general equality of conditions."[8] As Lester Thurow, the noted MIT professor, commented in a recent article in *Atlantic Monthly*, "How does one preach political equality in an economy of ever-growing inequality?"[9]

California's long-term economic and social strength will be in jeopardy if public policymakers and civic and business leaders do not fully commit themselves to confronting the dangerous trend toward "two Californias." Addressing this issue is a matter of common interest to all Californians. Indeed, a two-tiered economy and society pose a number of threats to the State's future. Educational failure will damage the quality of our workforce. Poverty will increase the fiscal burden on state and local governments. Fears for public safety will negatively affect private sector investment decisions. Most importantly, the very essence of the California dream will be lost.

The Double Bottom Line: Investing in California's Emerging Markets

Smart and successful private sector companies and entrepreneurs use good economic times to look ahead and make strategic investments to ensure their continued viability and growth. So should the State of California.

Addressing the threat of economic disparity is not only the smart thing to do, it is the right thing to do. As Professor Manuel Pastor of the University of California at Santa Cruz has noted, "A strategy without equity will shipwreck your competitiveness and your dignity." [10]



Source: Economic Policy Institute, January 2000

For more than 30 years, the question of growing economic inequality has been absent from the center of debate in California's civic, political, and financial circles. Old debates about income redistribution gave way to a paucity of dialogue and action in the arena of economic opportunity.

It is time to engage in a new discussion of how to enlarge economic opportunity for the California communities struggling in our midst. That discussion must occur across a broad public policy front and must consider how the assets and capital of this most dynamic of states can be deployed in pursuit of that cause — striving to meet the "double bottom line" of prudent investment and broadened economic opportunity.

It is in this context that the Treasurer's Office is launching a new initiative — *The Double Bottom Line: Investing in California's Emerging Markets* — to mobilize the powerful instrument of financial capital in new and innovative ways, consistent with the highest fiduciary standards, to reinvest in the State's at-risk communities and, thus, to build a stronger economic future for California.

As Bruce Katz and Katherine Allen noted in the *Brookings Review*, "Now is the time — with a booming economy and welfare reform's new focus on work — for the government and private sector to ...help poor inner-city residents find better opportunities for themselves and their children."[11]

As the State's chief investment officer, the Treasurer must be concerned with the future economic strength of California. There is a correlation between the State's quality of life, the equality of economic opportunity, and long-term economic success. In the end, if the State's quality of life diminishes, if communities are left to languish, and if there is a large and growing underclass, future economic prospects will be undermined. That will, in turn, have a direct and negative effect on the finances of state government and on the State's investment portfolios.

Conversely, if state investment policy can contribute to creating an upward economic spiral that produces more jobs and wealth, more disposable income for housing and for consumer purchases, and more revenues for public investment and quality public services, then the State's fiscal position and investment portfolios will be strengthened.

Building On *Smart Investments*

In June 1999, the Office of the Treasurer released *Smart Investments*, a report which highlighted the growth challenges facing this State and which articulated public investment policies to respond to those challenges. *Smart Investments* noted that California is on the cusp of an unprecedented wave of growth, with the State's population expected to grow by 12 million residents over the next 20 years. This surge in growth will equal that experienced in the boom years of the 1950s, 1960s, and 1970s combined and will come in the context of decades of underinvestment in the public fabric of the State.

Smart Investments recognized that, in the face of unprecedented growth, California cannot achieve long-term economic success if the environment is degraded and if there are pockets of poverty and economic struggle throughout the State. Accordingly, the report outlined a strategic and fiscally prudent approach to state infrastructure investment. This approach called for investments which support livable communities, sustainable development and sound environmental practices, and increased public investment in the communities left behind in California's economy.

Smart Investments noted that the growing gap between the "two Californias" is being increasingly reflected in how and where we live — with the economic and social distance ever growing be-

Smart Investments: From Ideas to Action

In June 1999, the State Treasurer released *Smart Investments* — a report that articulated a state investment policy to help ensure California's long-term economic prosperity. *Smart Investments* recognized that, as California faces unprecedented growth in the next two decades, it cannot achieve sustained economic success if the environment is degraded and if there are pockets of poverty throughout the state.

The report outlined a strategic and fiscally prudent approach to investment which called for state infrastructure investments that support livable communities, sustainable development and sound environmental practices. Equally important, it called for State investment in struggling communities to reverse a dangerous trend toward "two Californias" — one in poverty and the other enjoying an economic boom.

The following initiatives, implemented during the past year, mark a fundamental shift in state policies, directing more than $7 billion in state public program resources over the next three years in pursuit of "smart investment" goals.

Tax Credit Program Reformed: In June 1999, the California Tax Credit Allocation Committee, chaired by the Treasurer, adopted a new system for annually awarding $450 million in federal and state tax credits for the construction and rehabilitation of affordable rental housing — replacing the former administration's lottery system. The reformed program establishes a point system that, among other things, prioritizes projects in struggling neighborhoods in which the housing is part of a comprehensive revitalization effort and also gives priority to projects that meet a set of sustainable development goals. For example, projects within walking distance of transit, schools, parks and shopping get priority. The new system also rewards projects which leverage other financial resources.

Targeted Low-Cost Financing: The California Debt Limit Allocation Committee, chaired by the Treasurer, adopted new rules for the allocation of $1.6 billion annually in low-cost, tax exempt financing for affordable housing, pollution control, job creation and student loans. The new rules replaced a "first-come, first-served" allocation method. Under the new system, projects will be prioritized based on public policy objectives that target resources to lower-income communities, support sustainable development, and leverage public and private dollars.

Extra Credit Teacher Home Purchase Program: The Extra Credit program was adopted by the California Debt Limit Allocation Committee in January 2000. The program will provide $150 million in tax credits over the next four years to help more than 4,000 teachers, willing to serve in low-performing schools, purchase a home. Extra Credit will provide teachers with a tax credit worth approximately $37,000 over the life of a 30-year, $150,000 mortgage loan. The program is designed not only to assist teachers but also to help lift up the quality of schools in at-risk neighborhoods.

Low-Cost Local Infrastructure Loans: The State Treasurer's Office advocated for a new set of criteria for use by the California Infrastructure and Economic Development Bank in awarding more than $1.4 billion in loans for local infrastructure projects. The bank board, which includes the Treasurer, adopted criteria in December 1999 that will reward projects which help revitalize economically struggling communities and neighborhoods, and which support sustainable development and sound environmental policies.

tween our older cities, inner ring suburbs, and struggling rural communities on one hand and our wealthy urban enclaves and thriving suburbs on the other.

In the words of Professors Roberto Mangabeira Unger and Cornel West of Harvard University in *The Future of American Progressivism*, we now see "...a world of advanced sectors and regions connected with one another and weakly linked to the backward sectors and regions of their own societies."[12]

Smart Investments further recognized that the two central policy goals contained in the report — promoting sustainable development patterns and fostering community revitalization — are fundamentally linked and that there is a shared stake among all Californians in the achievement of both goals. Indeed, neither goal can be accomplished without the other.

Providing affordable housing, broadening economic opportunity, reaching a balance between jobs and housing, preserving the environment and quality of life, and sustaining economic progress are all matters which reach across neighborhood and community boundaries. No community stands in isolation.

The preservation of open spaces beyond the urban perimeter is tied to the stabilization and renewal of communities within the urban fabric. Population growth in the years ahead dictates that no community can be viewed as expendable. Air quality is affected by commutes across regions, including the travels of residents of urban core and inner ring suburban communities to jobs being created on the urban edge. Urban reinvestment can reduce auto dependence, traffic congestion, and air pollution.

High unemployment in struggling communities is exacerbated by the distance between where potential workers live and where jobs are being created. In addition, regional economic growth can be threatened by labor force imbalances, or what an article in *Brookings Review* referred to as "the mismatch of jobs — enough jobs but in the wrong places or at the wrong skill levels."[13]

And, the societal impacts which accompany economic hardship — from crime to physical decay — are rarely contained in the neighborhoods at the center of those impacts. There is an increasing body of work that not only speaks to the migration of economic struggle from inner cities to older suburbs, but also to the correlation between the fates of regions and the less prosperous communities within their fabric.

It is perhaps noteworthy that Californians ranked *both* the widening economic gap and diminution in the quality of life among their top concerns in the PPIC's 1999 survey.[14]

Smart Investments recognized that, in the face of unprecedented growth, California cannot achieve long-term economic success if the environment is degraded and if there are pockets of poverty and economic struggle throughout the State.

Smart Investments advanced the proposition that public investment policy could play a critical role in shaping the State's growth patterns and thus contribute to long-term sustainability and broadened equality of economic opportunity for struggling California communities. The report recognized that public investment was only one tool in a wide array of State public policy initiatives that must be seriously pursued to make a difference. But it is an important tool, nonetheless, given that the State is likely to commit tens of billions of dollars in infrastructure investment alone in the years ahead.

Since the release of *Smart Investments*, the Treasurer's Office has proceeded on a number of fronts to implement the policies outlined in the report. Marking a fundamental shift in State policies, the Treasurer's Office has targeted both existing and new public financing programs according to "smart investment" criteria and policies. Existing State financial assistance programs, such as the awarding of federal and State low income housing tax credits and the allocation of tax exempt financing for housing and job creation, have been reformed to focus on sustainable development and community reinvestment. The Treasurer's Office also successfully advocated for inclusion of "smart investment" principles in the State's new program to provide low interest loans for local infrastructure projects, and launched a new program to provide tax incentives for home purchase by teachers agreeing to serve in low performing schools, to help lift up the quality of schools in at-risk neighborhoods. All told, these adopted policy changes will direct more than $7 billion in public financial resources over the next three years in pursuit of "smart investment" goals. (See page 5*: Smart Investments: Ideas to Action*)

Capital Investment and Community Revitalization

While initial progress has been made on the road toward a new public investment policy that promotes sustainable growth and enhances opportunities for economic revival in the State's struggling communities, the journey ahead remains a long one. And, while there is growing recognition of the importance of promoting environmentally responsible growth and increasing political support in that regard, there does not yet exist the same level of political momentum for the equally important task of redirecting public policy energy and investment in ways that close the gap between rich and poor and that promote economic progress in the State's less prosperous communities.

Further, as progress in State public investment policies and programs is pursued, it is important to recognize that it is not enough for the State alone to adopt a new course with respect to investment policy. State efforts need to be matched with regional and local investment strategies that support community reinvestment as a key element of sustainable growth. It will take the full attention of all levels of the public sector — across broad policy fronts — to increase economic opportunity.

And, in the end, in our free enterprise system in which capital plays such a fundamental role in shaping our society, new public investment policies cannot fully succeed without engaging the powerful potential of the capital markets to create economic growth where it is needed most and where capital is least available. For, while public goods — from high quality infrastructure to community amenities to quality schools — and civic engagement are critical in setting a foundation for economic expansion, it is the engine of investment capital, coupled with entrepreneurship, that ultimately drives job and wealth creation.

As a recent study prepared for The Brookings Institution Center on Urban and Metropolitan Policy noted, "Ultimately, it is primarily businesses that create wealth and jobs. If the private sector is willing to work with government and development organizations to see, strengthen, and access inner-city market opportunities, we can realize the promise of a new, large scale wave both of business profitability and of sustained economic development in emerging neighborhood markets."[15]

For, while public goods — from high quality infrastructure to community amenities to quality schools — and civic engagement are critical in setting a foundation for economic expansion, it is the engine of investment capital, coupled with entrepreneurship, that ultimately drives job and wealth creation.

This is not to say that investment by the capital markets is, by itself, *the* answer to the economic and social woes that burden the "other California." Indeed, the answer must include a multifaceted public policy attack across a broad front to address the challenges facing struggling communities beyond the shortage of capital.

- The State must commit itself to a set of public investments — particularly in education and job skills training — which create the environment for economic growth. These investments, along with high quality public services and amenities, are not only needed to strengthen the fabric of at-risk communities, but also to break the cycle of disinvestment which has plagued them. As Katz and Allen noted in the *Brookings Review*, "People in these neighborhoods often face a triple whammy: poor schools, weak job information networks, and scarce jobs."[16]

- The State and local governments must embrace public policies — from land use practices to regulatory frameworks to infrastructure investment — that enable responsible and quality enterprises to competitively invest in these communities. Development of housing and business opportunities within the urban fabric can be a difficult proposition due to a range of challenges from land assembly, to the existence of contaminated brownfields sites, to high construction costs.

- Investments in public infrastructure and services must be accompanied by investments in the civic infrastructure of communities essential to sustained economic progress. The work of effective community based organizations and community development corporations must be supported. Resources for social services, childcare, and healthcare must be part of any effective strategy. And, no one should mistake the potential benefits of investment capital with the responsibility of the State, and the public realm generally, to care for and provide services to the poorest amongst us and those most in need.

- The availability of well-priced capital must be matched with businesses which have the capability and willingness to create profitable enterprises, employment, and/or real estate development which build and sustain communities at risk. Public, private, non-profit, and community efforts to create and increase entrepreneurial and business management capacity and skills must complement new capital strategies.

However, just as investment of public financial resources is a tool that must be brought foursquare to community revitalization efforts, private and publicly managed investment capital must be drawn to this end to the greatest extent possible. Indeed, engagement of the capital markets is particularly vital given the rapid pace of change in the global economic environment. This change is manifesting itself in California's own economic evolution — as witnessed by phenomena that include the decline in the manufacturing base and the ascendancy of the information economy. Thomas Friedman, in *The Lexus and the Olive Tree: Understanding Globalization* points out that America's emerging markets require special policy attention in this era of rapid global change, advocating for "initiatives that will improve access to investment capital in the most distressed, low-income communities, so that we are not just training people for jobs that are not available."[17]

At the same time that it is critical to call for increased capital investment in struggling neighborhoods, any such call must be accompanied by a definition of community revitalization which such investment should strive to bring about.

Community revitalization means improving the quality of life and stability of neighborhoods for current and future residents. It means making better use of our existing urban fabric through higher density, quality development and through reuse of abandoned sites. It means increased opportunities for homeownership and decent rental housing. It means enhanced economic viability and competitiveness — strengthening not only at-risk communities, but also regional economies. It means creating new economic opportunities — from quality jobs at wages which can support families to business ownership — for neighborhood residents and those outside the economic mainstream. It means creating value — from a sense of pride to broader wealth creation — not just for the neighborhood as a physical entity, but for the people who have made it their home. It means new attention to the quality of community design and to the quality of services — from healthcare to retail — available to neighborhood residents. Importantly, it means infusing new energy into and restoring hope for communities which have struggled hardest in this time of prosperity.

And as Thomas Tseng, research director for Community Development Technologies Center and former research fellow at Pepperdine University, noted, "Revitalization must recognize and build upon the rich and growing economic, social, cultural, institutional, and physical assets that already exist."[18]

The Confluence of Need and Opportunity

There is clearly a need for new capital investment to pry open the doors of economic opportunity for California communities left out of the boom of the last decade. The scarcity of capital — particularly equity — is a factor constraining economic development and community revitalization efforts.

Capital flows have been inhibited by a range of circumstances which include:

- the distance between capital sources and communities in need;
- persistent, negative stereotypes about the risks of investing in California's underserved communities;
- an undervaluation of the assets and economic power of neighborhoods traditionally viewed as distressed; and
- a lack of information as to the opportunities for capital to be successfully invested in communities historically bypassed by institutional capital sources.

As Glenn Yago of the Milken Institute observed in "Cities in the New Economy," domestic emerging markets continue "to be overlooked and untapped due to misperceptions and lack of information. Demand for capital remains unsatisfied."[19]

It is estimated that only 1 percent of U.S. domestic private equity capital is currently targeted toward real estate development and businesses in core urban areas.[20] Only 1-2 percent of equity capital invested in the United States is flowing to minority businesses.[21] A 1999 Milken Institute study, *Mainstreaming Minority Business: Financing Domestic Emerging Markets*, found that only a small portion of the $144 billion annual demand for capital in the minority business community, much of which is located in at-risk communities, is being met, despite rapid growth in the minority business sector.[22] As the report put it, such businesses "are thirsting for capital resources." It further noted that minority businesses were significantly more likely to be denied bank credit, and when successful, tend to receive smaller loans relative to comparable businesses.

These findings are reflected in California. A recent assessment of unmet credit needs in San Diego found that while low income census tracts comprise 5.4 percent of all tracts within the county, only 3.3 percent of small business loans made in 1998 were in those neighborhoods.[23] And, as noted in, "Common Paths: Connecting Metropolitan Growth to Inner-City Opportunities in South Los Angeles," South Los Angeles has 40 percent fewer lending institutions per capita than the rest of the county.[24]

It is striking to compare the ease with which billions of dollars of American capital have flowed during the past decade to risky and highly volatile developing countries across the globe and the difficulties faced by California's own underdeveloped communities as they struggle to attract desperately needed capital investment to fuel their resurgence.

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California's pension funds — the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS) — have over $5 billion invested in the so-called emerging markets overseas.[25] While the commitment of that capital is playing a role in lifting up some of the poorest nations on this earth, returns from those markets have been uneven. An examination of the returns of CalPERS for the three years ending December 1999 showed annualized losses in Indonesia of minus 29 percent; in Malaysia of minus 24 percent; and in the Philippines of minus 25 percent.[26]

It is time to examine anew the confluence between the need for capital in California's undercapitalized communities and the opportunities that exist for the financially prudent investment of capital in our own emerging markets.

For all the challenges which California's emerging markets face, it is worth noting that one does not need a State Department, Amnesty International, or CIA report to underwrite their essential market stability, and that these markets are located in an economically diverse nation-state of 34 million people which is home to the world's seventh largest economy.

Indeed, despite all their struggles, the California communities facing economic challenges are rich in underlying assets, strategic advantages, and potential. Beyond the fact that many of these neighborhoods are defined by quality housing stock, strong community design, and historic strength, they also contain inherent market strengths. Here are just some of the factors that speak to the potential of California's emerging markets.

Many of these communities sit at strategic locations within their regions — proximate to major transportation corridors, downtown business districts, regional business clusters, and significant consumer markets, with underutilized infrastructure that can support business expansion. South Los Angeles offers many of these advantages. So does Oakland — which has an emerging "new economy" with more than 350 high tech businesses and which recently won recognition for being home to five of the nation's 25 leading inner city companies.[27]

These communities offer the advantage of an available and growing workforce in an era in which labor supply will be a critical factor in continued economic growth. As Professor Michael Porter of the Harvard Business School has pointed out, "In the new economy, the available and growing labor force will be in inner cities. More than 54 percent of workforce growth will come from minority communities, which are heavily concentrated in cities and inner cities."[28]

Population increases will further strengthen already underserved consumer markets in many of these communities. Coupled with already relatively high densities, this will translate into significant economic power in the years ahead. The Social Compact — an alliance of major corporate partners — has studied, through its Neighborhood Markets Drill Down Initiative, the market potential of neighborhoods normally characterized as distressed. For example, its market analysis of the "lower income" Little Village community of Chicago painted a picture of market strength not before seen. The analysis showed that a neighborhood thought, by traditional analytical measures, to have a population of 66,000 people with an aggregate income of $585 million actually was home to 92,000 people with a total income of $773 million, due to a number of factors such as the unrecorded economy and population undercounts. With its adjusted population and buying power, Little Village turns out to have a lower rate of crime per 1,000 persons than Forest Glen, the highest income neighborhood in Chicago, as well as more households earning over $50,000 per year.[29]

And, despite pressures brought about by the evolving economy, many of these communities are still home to productive economic sectors that can survive and thrive with public and private sector support. As *Rebuilding LA's Urban Communities: A Final Report from RLA* pointed out in 1997, many vibrant industries are centered in and around the Los Angeles Basin's less prosperous neighborhoods. Seventy-five percent of the region's textile and apparel production firms, with total sales of $10 billion annually, and almost 60 percent of ethnic food processing firms, with annual revenues of $12 billion, are located in such neighborhoods. Approximately 25 percent of Los Angeles based biomedical firms are found in or near these communities, employing l0,000 people from these areas.[30]

Yet, despite the potential which exists, California's emerging markets have suffered from a lack of marketplace knowledge to guide and support needed capital investment. Contributing to this phenomenon are a number of factors. They include a lack of familiarity with those markets by capital sources, an historic underinvestment which has led to a relative scarcity of market knowledge, and a failure to take into account the dramatic demographic shifts — in ethnicity and population growth — that have occurred in underserved communities.

Given that quality information is at the heart of the investment decision making process, the lack of information is a decisive deterrent to the flow of capital.

Interestingly enough, one factor which has contributed to the perception of domestic emerging markets as places scarce in economic potential has been a flood of government statistics which rightly focus, for their purposes, on indicators of poverty and need. By their very nature, those statistics are not designed to provide data on underlying community strengths and assets which can support needed capital investment. The impact of such data is particularly pronounced in the absence of high quality information about market opportunities. As Porter stated, "We have learned that there is a roomful of books and articles on urban poverty, but virtually nothing on urban business."[31]

A 1999 report prepared for The Brookings Institution commented that "America's inner cities have vast undervalued assets that are largely unseen by conventional business. The resulting underinvestment reflects a serious information gap affecting neighborhood markets. In today's information age, where market intelligence is the single most valuable commodity in business, little reliable, accessible data or knowledge is available about emerging markets."[32]

Similarly, a 1999 report to CalSTRS by the system's professional real estate advisors spoke to the distance yet to be traveled in educating American capital about domestic emerging markets. "Due to market inefficiencies and negative perceptions," the report stated, "it appears that urban areas have been largely overlooked by mainstream investors, including the traditional real estate advisory community, despite being attractive investment opportunities." The report also stated that "one reason these opportunities have been generally avoided by the advisory community is, in all probability related to the lack of ethnic diversity among the senior ranks of virtually every traditional real estate advisor."[33]

In 1999, *INC.* magazine, in conjunction with the Initiative for a Competitive Inner City (ICIC), created the Inner City 100 list, ranking inner city growth companies. The CEOs of those companies which had average annual compound growth rates of 44 percent and which created 4,695 jobs between 1993 and 1997 — cited "as competitive disadvantages negative *perceptions* about their neighborhoods — especially in regard to crime — far more often than they cite *actual* crime rates or an inadequate labor pool."[34]

But times are changing, as the facts of opportunity begin to spread, fueled by an initial set of relevant public and private market studies, by the financially productive movement of capital to at-risk communities, and by verifiable success stories. Those stories range from retailers profitably re-entering inner city markets to lenders finding new opportunities in underserved communities because of the mandates of the federal Community Reinvestment Act (CRA) of 1977.

Here are just a few examples of the expanding body of knowledge which can lay the foundation for an enhanced flow of capital to underserved communities.

- A 1999 Housing and Urban Development (HUD) study showed that the retail purchasing power of America's inner city markets exceeds by nearly $9 billion annually the retail sales in those markets. In Watts alone, the gap is nearly half a billion dollars a year — showing that retail investment is needed and can be successful.[35]

- Retailers are finding that underserved markets can represent highly profitable opportunities. A study by the Boston Consulting Group found that inner city supermarkets can generate sales per square foot up to 40 percent higher than regional averages. Sears Roebuck stores located in central cities are grossing triple the company average and the Super K in Oakland has sales that are 50 percent higher than comparable stores in the chain.[36] The Pension Consulting Alliance (PCA), in a report to CalSTRS, stated, "The booming economy, falling urban crime and retail crowding in the suburbs have emboldened a handful of companies to set up shop in historically neglected neighborhoods. These companies have found that developing modern retail facilities in these urban neighborhoods is simply good business."[37]

- Ethnic and minority markets — often centered in traditionally underserved communities — are growing dramatically. The Hispanic consumer market has gone from $208 billion in 1990 to an estimated $383 billion in 1999, and the revenues of companies listed on the Black Enterprise 100 have increased from $470 million in 1972 to over $13 billion in 1997.[38]

- Community reinvestment vehicles are standing the test of time. Community development financial institutions in California have established strong track records of investment in businesses, housing, and community development organizations in low and moderate income neighborhoods across the State. For example, the Savings Associations Mortgage Company Inc. (SAMCO), a California-based lending consortium of over 75 savings and loan associations, has been actively engaged in community reinvestment lending, targeted to multi-family affordable housing, since 1969, with a proven record of performance. SAMCO has placed more than $380 million in loans and ended 1999 with a delinquency rate below the industry average for standard, multi-family market rate loans. As another example, the Local Initiatives Support Corporation (LISC) has channeled financial resources to communities for housing, commercial revitalization, community development and job creation since 1979. LISC, along with its investors, contributors, and affiliates, invests more than a half a billion dollars a year.[39]

- The market for Low Income Housing Tax Credits has evolved dramatically over the past decade and a half. While investors initially sought returns of 20 percent plus due to perceived risk, investors now receive returns in high single digits or low double digits, with demand by investors exceeding the supply of tax credits available for purchase.

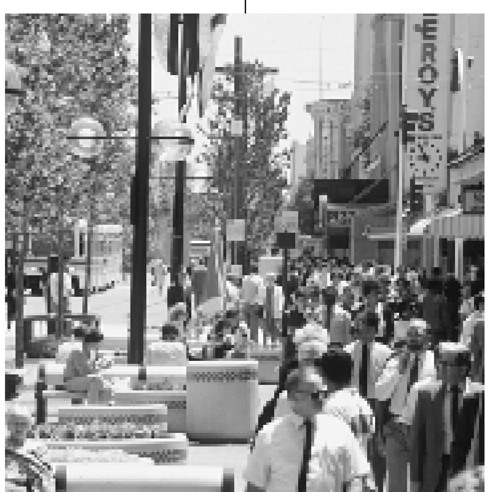
Partly due to the positive experience of lenders under the CRA and partly due to the increased market knowledge, investment vehicles, targeted to distressed communities and sectors, have emerged. The success of these ventures is breaking down old myths about the risk and return of community reinvestment.

But it is perhaps the results of the CRA which are providing some of the best evidence of the market opportunities that exist in communities too often neglected by capital markets. Enacted at a time when American lenders were greenlining Latin America, and redlining communities in our own backyard, the CRA has required lenders to maintain a continuing and affirmative obligation to help meet the credit needs of all of the communities they serve.

Over the course of its history, the CRA has resulted in more than $1 trillion in new investment and lending commitments to traditionally underserved communities.[40] Lenders subject to the CRA are, in many respects, two decades ahead of most other private sector capital sources and pension funds in understanding the extent to which there are solid risk-adjusted returns in community reinvestment. As The Brookings Institution study noted, "Conventional businesses are currently in the position that conventional banks were in two decades ago. They are undervaluing inner-city markets and therefore under-serving the inner-city."[41] And what lenders have found in practice is now being backed up by the facts of their experience.

In 1998, the Federal Reserve's Greenspan stated that the CRA "has helped financial institutions discover new markets that may have been underserved before...."[42] Greenspan further noted that there is "no evidence that banks' safety and soundness have been compromised by [low and moderate income] lending, and bankers often report sound business opportunities."[43] Greenspan's observations were reinforced by a 1997 Federal Reserve study which concluded that there was no statistically significant variation in profitability levels between banks that make high percentages of home loans in lower-income neighborhoods and banks that make few such loans.[44]

The expanding knowledge about community reinvestment opportunities is being accompanied by a developing investment dynamic — beyond the efforts of lenders operating under the CRA — which is beginning to move capital to underserved communities for business expansion and real estate development. Partly due to the positive experience of lenders under the CRA and partly due to the increased market knowledge, investment vehicles, targeted to distressed communities and sectors, have emerged. The success of these ventures is breaking down old myths about the risk and return of community reinvestment.



The California Community Mortgage Fund, which invests in mortgage loans on affordable multi-family housing units and commercial income properties located in underserved neighborhoods, has generated annualized returns of 9.8 percent since inception.[45] The Massachusetts Capital Resource Company has invested $430 million in over 200 companies, resulting in the creation of over 15,000 jobs, with $260 million of that amount invested in cities and towns designated as Economic Target Areas by the Commonwealth of Massachusetts. Average returns have been estimated to exceed 20 percent — with recent year results even stronger.[46] And, the Massachusetts Housing Investment Corporation reports cash on cash returns of 15 percent on urban investment funds.[47]

More investment funds are entering the market. The Genesis LA Real Estate Investment Fund will focus on development in underserved Los Angeles neighborhoods. The Bay Area Family of Funds — co-sponsored by the Bay Area Council, composed of many of the region's largest private sector employers — is targeted to creating smart growth and economic prosperity for the residents of 46 low income neighborhoods in the Bay Area.

A New Era of Investment: A Leadership Role for California

The stage has been set for a new era of capital investment that can help bring new hope, opportunity and progress to the "other California." This new era has at its foundation the recognition that capital can be invested in ways which meet a "double bottom line" — the achievement of risk-adjusted, market returns and the creation of new economic vitality in struggling communities. It moves away from the old notion of community reinvestment as a secondary or lesser opportunity to a new understanding of the real risks and rewards of investing in sectors and communities most in need of capital.

The State of California can and must play a critical leadership role in this new era in which the power of investment capital is deployed in a battle against the inequality of economic opportunity. California can lead by setting an example in its own investment policies and practices and by fully engaging public and private entities which control capital in this cause.

The State of California is one of the largest investors in the global economy. Its two largest pension funds — CalPERS and CalSTRS — have over $270 billion in assets.[48] The Pooled Money Investment Account (PMIA), the short-term funds of the State and more than 2,500 local agencies, currently holds over $34 billion.[49] These three pools of capital, which must be managed in a fiduciarily sound manner, contain investments that include foreign and domestic stocks and bonds, private equity and venture capital, and holdings in real estate and development. The pools invest in partnership with other public funds and with the private sector, and like their private sector counterparts, seek out investments which can bring risk-adjusted, market returns.

Beyond the management of its own portfolio, the State is involved in the arena of investment in a number of other ways. For example, the State of California owns and leases over 34 million square feet of office space — more than all the private office space in downtown Los Angeles and three times the amount in downtown Sacramento — making it a significant investor in California's real estate markets.[50] As another example, the California Debt Limit

Allocation Committee, chaired by the Treasurer, annually allocates $1.6 billion in low cost financing for purposes ranging from the construction and rehabilitation of affordable rental housing to the provision of home mortgages to the expansion or construction of manufacturing plants.

By virtue of its investment power, the State of California is integrally woven into the fabric of the global capital markets. This power comes with the responsibility to manage investment funds wisely. It also comes with the opportunity to affect the marketplace and, thus, to set a leadership example in a new movement of capital to communities in need.

The challenge for California is to find ways to invest the State's assets and capital in a manner fully consistent with the highest fiduciary standards and which yields competitive market returns, *and* to deploy assets and capital, within that context, to broaden economic opportunity and thus contribute to California's long-term economic success.

> In 1998, the Federal Reserve's Greenspan stated that the CRA "has helped financial institutions discover new markets that may have been underserved before...."

The Double Bottom Line: Policies for a New Investment Dynamic

As the State's chief investment officer, the Treasurer is responsible for managing the PMIA, sits on the boards of CalPERS and CalSTRS and oversees a range of public financing programs. In those collective venues, the Treasurer's Office sits at the intersection of capital investment and public policy — charged both with managing funds as a fiduciary and promoting public policies which build the State's long-term fiscal strength. It is in light of these responsibilities that this office is pursuing *The Double Bottom Line*, to create a new investment dynamic for California which links public purpose with the jet stream of the capital markets.

The Double Bottom Line is a call to action. It builds on the policies and initiatives of Smart Investments by challenging the public sector — from public pension plans to state and local governments — to invest capital, in a financially prudent manner, to help lift the economic prospects of California's struggling communities. It calls on the private sector — the engine of our remarkable economy — to join the public realm in finding and making investments that can help close the gap between the "two Californias"; bring new life and vitality to the neighborhoods most at risk; and secure the State's economic future.

The Double Bottom Line goes beyond the advocacy of policies. It creates a path for public and private sector capital by setting forth specific investment models which meet the test of fiduciary soundness and broader economic opportunity. It is a concrete plan of action which, it is hoped, will serve as the foundation for a new wave of investment to sustain California's economic and social fabric.

The Double Bottom Line is based on five key policies and is buttressed by specific investment initiatives that serve as models for the implementation of these policies. The implementation models represent a beginning — a foundation upon which to build. They are not meant to be all encompassing, but rather reflect initiatives the Treasurer's Office is pursuing to establish a new policy direction. (The model initiatives are summarized on page 24.)

The policies contained in *The Double Bottom Line* need to be applied to a broad range of State programs, assets, and investments. For example, the Legislature and the Governor are currently considering substantial budget augmentations and a general obligation bond measure for affordable housing. The policies of *The Double Bottom Line* — such as targeting communities and Californians most in need and leveraging additional capital investment — should be incorporated in any housing assistance measure enacted this year.

The policies of *The Double Bottom Line* are set forth below:

■ Public Pension Funds and Investment Pools Can Lead the Way in a New Era of "Double Bottom Line" Investment — Achieving Successful Investment Results and Broadening Economic Opportunity.

Public pension funds and investment pools represent an important source of capital in the American economy. The top 200 public pension funds across the nation hold close to $2 trillion in assets.[51] And over $400 billion is invested by California public pension funds alone in a wide range of investments from low yield, low risk fixed income securities to higher risk, higher return venture capital vehicles.[52] In addition, there is over $60 billion in state and county short term investment pools, which by their very nature, must be invested in low risk, secure instruments which allow for liquidity.[53]

As noted earlier, the absolute obligation of public pension and investment funds is to invest in a fiduciarily sound manner to meet obligations to taxpayers and pension system members. Such funds also have a stake in the continued economic strength of California, given the relationship between the fiscal health of the State, revenues generated by the economy, public sector costs to mitigate social and economic dysfunction, and the reliance of public funds on state and local government contributions to maintain viability.

Also as noted above, California's public pension and investment funds are an essential part of the capital markets as investors in a broad band of sectors and asset categories across the nation and the globe. Those funds share with their private sector counterparts the mandate to seek risk-adjusted, market returns. They also share an obligation to seek out new investment vistas which can achieve that mandate — particularly if those vistas can bolster and sustain the California economy which is foundational to their continued health.

The Double Bottom Line calls upon public pension funds and investment pools to seek out sound investments which meet their risk and return criteria and which provide equity and debt capital for real estate and business development in California's emerging markets. In doing so, California's state and local public funds can lead the way in a new era of financially prudent investment which helps rebuild the State's struggling communities.

The Double Bottom Line calls upon public pension funds and investment pools to seek out sound investments which meet their risk and return criteria and which provide equity and debt capital for real estate and business development in California's emerging markets.

Importantly, capital investment by pension funds and investment pools differs from that undertaken through public agency programs such as tax exempt financing, low income housing tax credits, and guaranteed or subsidized lending for community and business development. The former must seek out opportunities offering risk-adjusted, market returns, while the latter are designed to serve projects and needs which are not financially feasible, absent public financing mechanisms, given the pricing and terms of market rate capital.

In pursuing investment opportunities in California's emerging markets, public pension and investment funds should structure investments to meet a number of criteria, as appropriate to the type of investment. However, it should be pointed out that community reinvestment vehicles and structures need not be (nor have they proven to be) any more complex than other market products.

- Investments should leverage private capital, not only to expand the impact of investment, but also to ensure private sector validation of investment opportunities. Indeed, investments by public funds can, by their nature, leverage significant private co-investment. For example, in 1999, the Treasurer's Office purchased $400 million in mortgage securities made under the CRA to low and moderate income households or in low and moderate income neighborhoods. To complete the transaction, Freddie Mac purchased $890 million in CRA mortgages to meet the Treasurer's Office investment requirements.

- Investment structures should align the interests of investment managers and pension systems through mechanisms such as performance-based compensation. Investments should be made through managers who demonstrate strong market knowledge and proven capability.

- Investors should avail themselves not only of existing delivery networks such as lenders, secondary market mechanisms, and private equity firms which have the capacity to move capital to target markets, but also available enhancements such as guarantees by government sponsored enterprises (i.e. Freddie Mac, Fannie Mae). In addition, investors should explore the opportunities which exist at every level of the capital structure — from equity to debt — and which are available through a myriad of investment structures such as securitization, venture capital funds, and mezzanine funds.

- Community reinvestment initiatives should be structured to contribute to community revitalization while achieving market returns. This means that public pension and investment funds should seek investment partners who themselves are structured to accomplish that goal. Indeed, creating businesses and employment appropriate to the community was cited by Porter in his 1995 work, *The Competitive Advantage of the Inner City*, as an important ingredient for the sustained success of revitalization efforts. In this regard, public pension and investment funds should seek investment partners/managers who have the capability to build the management strength of the companies in which they invest — much as is done in the venture capital field. In addition, investment vehicles should have the capability to move capital in the increments appropriate for community reinvestment. Often, infill investment opportunities — from housing to business expansion — are of a smaller scale given the nature of development within the urban fabric.

Public pension funds are already participants in a variety of ventures on the innovative front of capital management, particularly in the areas of real estate, venture capital, and private equity for businesses. Community reinvestment initiatives should emulate what have proven to be the best features of other progressive investment vehicles. For example, public funds should require substantial contributions by general partners charged with managing investments. As another example, funds may choose to limit their participation as a percentage of an overall fund to reduce risk and to ensure co-participants. As a final example, investment vehicles targeted to community reinvestment, in which public funds participate, should be based on clearly defined business strategies and identified capital needs, with flexibility given to respond to market changes and to take advantage of evolving investment opportunities.

Most importantly, to ensure the funds' own financial soundness and to build a long-term community reinvestment dynamic, these investments must be viewed and approached as *primary* opportunities offering strong returns — not as investments of lesser worth agreed to as a matter of politics.

As with other new investment fronts, extra effort may be required at the front end to implement effective community reinvestment initiatives. If properly approached and implemented, the results at the back end — in return, portfolio diversification, and economic benefit to the State — will be worth that effort.

Over the past several years, models have been established for public investment fund entry into new markets which offer the potential for strong returns *and* benefit to the California economy. In 1992, CalPERS identified a market need — the absence of capital for California homebuilders in the midst of the recession and in the wake of severe dislocations in the real estate lending markets. This need for capital was matched by an opportunity for prudent investment given that there was demand for housing, albeit reduced due to the recession, in the context of scarce development and construction financing availability for many California homebuilders. CalPERS decided to initially allocate $525 million in equity capital for investment in California housing development, with the funds to be managed by a set of advisors, each required to co-invest with CalPERS and each compensated on an incentive basis tied to performance. Since its inception through September 1999, the program has yielded an annualized return to CalPERS of approximately 25 percent while financing the construction of 19,000 homes for Californians.[54]

Another example is the California Emerging Ventures investment program established in 1998 by CalPERS to invest $350 million in venture capital, with an emphasis on California firms. The investment program is administered by a private entity — Grove Street Advisors — which is charged with finding venture capital opportunities, particularly those of a smaller scale which would be difficult for CalPERS to consider directly. To date, the results have been excellent, with returns to CalPERS of more than 100 percent. Approximately 130 California based private companies have received venture capital through this program. Ten of those are already public with a combined market capitalization of $21 billion. The program is not only a financial success, but also is contributing to California's economic future through the creation of environmentally clean commerce for the 21st Century.[55]

Investment opportunities in California's underserved markets can offer the same "double bottom line" potential. PCA spoke to both return potentials and the ancillary benefits of urban housing investment in a report to the CalSTRS Investment Committee in February of this year. The report noted that "the fact that larger capital sources have bypassed this area [urban housing investment] in and of itself creates some opportunity." The report further stated that, "There are a number of other ancillary benefits associated with urban housing developments. Infill development offers an opportunity to revitalize older declining neighborhoods, has the potential to take advantage of and enhance existing public transit alternatives, and will promote additional investment and economic activity by creating demand for more goods and services. The use of infill parcels for residential development can minimize the consumption of agricultural land and other open space at the urban fringe and reduce long commutes, automobile use and fuel consumption by creating housing close to the central city and to public transit."[56]

As with other new investment fronts, extra effort may be required at the front end to implement effective community reinvestment initiatives. If properly approached and implemented, the results at the back end — in return, portfolio diversification, and economic benefit to the State — will be worth that effort.

■ Public Pension Funds Must Broaden Their Pool of Investment Managers to Capitalize on California Emerging Market Opportunities.

At the same time that public investment funds take a leadership role in creating joint public/private models for community reinvestment, the funds must also take the organizational steps required to avail themselves of the full range of opportunities which exist for private equity and real estate investment in underserved communities. Such efforts are particularly important given the institutional and cultural biases that have inhibited full exploration of investment opportunities in these communities.

Quality investment management personnel with sector expertise and commitment, operating in the best possible organizational structure, are key to successfully implementing new investment strategies. This notion is hardly a novel one — indeed, it underpins the successful implementation of business and investment strategies generally. The selection of investment managers and partners is among the most critical decisions which private and public investors make. And most successful investment funds not only build relationships with proven and experienced partners, but also are on a constant search for the next generation of competitive, emerging talent best positioned to help the funds realize success into the future in rapidly evolving markets.

In this regard, public pension funds engaged in community reinvestment must not only be committed to partnering with proven investment managers of the highest quality, but also must establish organizational structures which allow them to identify the future talent base for the years ahead. By doing so, the funds can accomplish two objectives — build a "farm team" of well qualified, competent professionals and widen the net of investment opportunities to include smaller entrepreneurial investment vehicles.

Models for such an approach have already been established in other investment arenas. For example, the California Emerging Ventures program at CalPERS referenced earlier accomplishes this purpose with respect to the venture capital markets. Similarly, the Manager Development Program, within the CalPERS equity portfolio, was established in 1998 to contribute to the achievement of strong returns, broaden the pool of future investment managers, and accord CalPERS an equity stake in growing investment companies. Under that program, CalPERS is partnering with two firms that will, in turn, select start-up investment management firms to invest in equities on behalf of CalPERS. CalPERS has allocated up to $3 billion to this program. In addition, CalPERS has set aside $40 million in capital to take equity positions in start-up investment firms.

A similar approach also makes sense with respect to community reinvestment. For example, as Porter pointed out in the *Harvard Business Review*, today's large and growing pool of talented ethnic and minority managers — many of whom have roots in and knowledge of underserved markets — have the networks, knowledge, and skills that can contribute to the successful deployment of capital and the building of entrepreneurial enterprises in those markets. As of 1977, there were just over 3,000 MBAs being conferred each year to African Americans, Native Americans, Hispanics, and Asian-Pacific Islanders. As of 1997, that number had grown to more than 15,000 — with many now ascending to the top ranks of America's premier investment companies and poised to lead firms in their own right.[57]

Accordingly, this initiative proposes that California public pension funds — and specifically CalPERS and CalSTRS — establish New Generation investment manager programs in the areas of private equity and real estate community reinvestment. These programs, in addition to partnerships with the most seasoned managers, can help boost present and future investment results and help discover new and profitable investment opportunities.

■ Public Financial Resources and Assets Should Leverage Capital Investment in Economically Struggling Communities.

In the context of the capital shortages that plague many California communities, it is critical that State and local programs providing financial assistance for business, community, and economic development — as differentiated from investment programs of pension funds and public investment pools — be focused sharply on sectors, communities, and enterprises for which the lack of adequate capital is a reality. This targeting is particularly important in light of the fact that, in today's capital marketplace, many sectors and communities do not want for reasonably priced equity and debt.

Simply stated, precious public program dollars should flow to where the need is greatest both for capital in the aggregate and well priced capital in particular. Public investment should not replace private sector investment.

Public program funds must be used to reach segments of the market which cannot be reached or effectively served by the capital markets, on their own accord, due to factors such as pricing and structure. To accomplish this goal, public financial assistance programs must establish effective evaluation, outreach and delivery mechanisms to ensure that they are serving the markets and communities truly in need.

Moreover, public financial assistance programs cannot be viewed on a stand alone basis — both because of the relative limitations on public resources measured against the need for capital in California's struggling communities — and because of the synergy created when public dollars are blended with private sector entrepreneurship and capital.

> The leveraging of public financial assistance programs with private capital accomplishes another important objective. It imparts to the capital markets a public confidence in the efficacy of community reinvestment through the commitment of resources and it signals to capital markets a recognition by the public sector of the importance of the policy goals at hand.

If properly structured, public sector community and economic development program resources can be the driver of multiples of investment beyond public dollars. For example, public monies can be used as an incentive for secondary market purchases of community and economic development loan portfolios, thereby producing capital for additional lending. A recent report to the CalSTRS Investment Committee about the potential for successful investment of CalSTRS capital in underserved urban communities, for example, noted that public program funds can serve to enhance the risk return equation for urban reinvestment ventures.[58]

The leveraging of public financial assistance programs with private capital accomplishes another important objective. It imparts to the capital markets a public confidence in the efficacy of community reinvestment through the commitment of resources and it signals to capital markets a recognition by the public sector of the importance of the policy goals at hand.

The programmatic efforts taken to implement *Smart Investments* have incorporated the principles of targeting and leverage. The Low Income Housing Tax Credit program includes leveraging of public financial contributions with private equity and lender debt as one of the key factors in determining the award of credits. Similarly, the competitive process for awarding low cost, tax exempt financing for rental housing development and industrial development projects rewards projects which utilize leverage. And both the tax credit and tax exempt financing programs accord priority to communities facing economic struggle.

Many local governments have also incorporated these principles in their own programmatic efforts, using resources such as tax increment financing and federal Community Development Block Grant funds as the tools to induce private investment in targeted neighborhoods. For example, the Mayor's Office in Los Angeles, working with the non-profit Genesis LA organization, is hoping to apply approximately $150 million in public funds to leverage over $1 billion in private capital — including investment by the Genesis LA Real Estate Investment Fund — to develop 15 priority inner city sites.[59]

These same principles of targeting, leverage and synergy should be applied broadly to the assets and relevant programs of the State to bring about increased capital investment in economically struggling sectors and communities. While the magnitude of such assets and programs may not be large in the context of the overall economy, they encompass substantial expenditures and, therefore, must be focused to serve the State's economic and public policy needs.

For example, the leasing and development of State office buildings should be viewed not only in the traditional context of cost efficiently meeting State space needs, but also in the broader context of investing substantial State program resources to leverage private real estate investment which energizes California communities.

As another example, State economic and community development lending assistance should be used as an incentive to induce private lending, not as the sole lending resource itself. Neither should it be used merely as a lower interest rate alternative to needs that can be met by the private markets. Such programs should be structured to align the interests of the public and private sectors with risks shared appropriately through mechanisms such as loan loss reserves mutually funded by private lenders and the public sector — and with private sector participation in evaluation and underwriting of transactions. Such programs should also utilize existing, efficient financial delivery networks to penetrate markets and to begin to adapt such networks to community reinvestment products. Public programs which share risk and which build on existing financial structures have a better chance to succeed and, thus, to evolve into mainstream private lending and investment programs.

A good example of a program incorporating these concepts is the CalCAP small business lending program administered by the California Pollution Control Financing Authority (CPCFA). Under CalCAP, nine California lenders make loans to small business enterprises which otherwise would not have access to capital. The participating lenders and CPCFA fund a loan loss reserve — generally of 8 percent — to stand behind the lender's portfolio of loans. To date, CalCAP has generated approximately $380 million in lending, with every dollar of CPCFA contribution matched by more than $23 of private lending.[60]

The concepts of targeting and leverage to induce appropriately structured capital investment where it is needed most must be central to State program investment policy. Accordingly, *The Double Bottom Line* proposes model programs which not only focus public monies on communities in need, but also use public dollars to create private investment.

A program of market research, undertaken on a partnership basis, can capitalize on the nexus between information technology and financial technology — two fields in which California is a leader — to provide competitive advantages for the State's economy.

■ State Government — in Partnership with Local Governments, Educational Institutions, Foundations and the Private Sector — Should Spur Capital Investment in Historically Overlooked Communities by Funding Critically Needed Market Research.

In an era in which information is the key to unlocking the doors of capital investment, state government can spur needed investment by helping create the wider body of knowledge as to the opportunities for capital to be successfully invested in California's emerging markets. This means that the State should join in partnership with local governments, educational institutions, foundations, and the private sector to fund critical market research that can serve as the basis for the subsequent capital investment in those markets. The research can build on the wealth of raw data which has been assembled by government — for example, through HUD, the Department of Commerce, and the SBA — for a variety of program purposes and which now should be made available to foster greater market knowledge. The market research itself must be undertaken by credible entities which can be relied upon by the capital markets for investment information and guidance.

A program of market research, undertaken on a partnership basis, can capitalize on the nexus between information technology and financial technology — two fields in which California is a leader — to provide competitive advantages for the State's economy.

Such an approach would be consistent with a long history of public efforts which have provided the foundational research that made possible subsequent private investment.

Examples of the efficacy of public sector research and development initiatives are abundant. The National Institutes of Health (NIH) is one of the world's foremost biomedical research centers conducting work not only in its own laboratories, but also through the work of scientists across the world. NIH research has advanced the understanding and treatment of disease, leading to many commercial applications, particularly for pharmaceuticals. Its research has been the basis of so much of what now exists in the medical field — from the vaccine for rubella to the development of drug therapies to prevent the transmission of HIV from mother to infant.[61]

Similarly, for over 30 years, NASA has facilitated the secondary use of its technology for the public and private sectors. Technologies developed for NASA have found more than 30,000 secondary commercial uses in products, ranging from tennis shoes to sunglasses to medical equipment. And in 1993, NASA developed the TAP-IN program to help companies access and apply defense-related technologies and to help defense dependent companies enter new markets.[62]

The same principles of publicly-driven research and development should be applied to the important area of community reinvestment.

Capital sources often move to known opportunities with understandable risks. Ventures which require de novo research can be at a disadvantage, both from a cost and cost of effort standpoint. The absence of information — or the presence of the unknown — may lead not only to a reticence to invest, but also to requirements for higher return expectations than otherwise might be demanded.

Quality information, available to investment decision makers, is particularly important in the arena of community reinvestment for the reasons cited earlier: the lack of market data resulting from a lack of historical investment; government statistics which speak to economic needs as opposed to market opportunity; the rapidly changing demographics of underserved communities; and the prevalence of negative stereotypes. Accurate data on key performance indices — such as rates of return, loan delinquencies, and capitalization rates — can inform investors as to the real risks and rewards of investing in California's emerging markets.

History has shown that information can make a critical difference. Lenders operating under the CRA have acquired the market knowledge over the past two decades to intelligently move capital to previously underserved communities and to do so profitably. Indeed, it is worthwhile noting that lenders have not only increased their community reinvestment lending, but also their level of equity commitments as their market knowledge has broadened and as their comfort level has grown. Every time a credible new investment vehicle targeted to underserved areas is created and succeeds, knowledge of that market activity spurs further interest in the broader investment community, laying the foundation for even more investment.

How investment in information can serve as the basis for increased capital flows is borne out by specific examples:

- The Milken Institute's *Mainstreaming Minority Business* report has set the stage for public and private efforts to create secondary market mechanisms for small business lending to increase the flow of capital to underserved communities.
- Grants from lenders provided the resources for the market assessment underpinning the efforts of Genesis LA to create an investment fund for real estate development targeted to the low and moderate income neighborhoods of Los Angeles.
- A research project by CalSTRS' professional advisors examining investment opportunities in urban core areas led to a recommendation by CalSTRS investment staff and those advisors to commit substantial capital to a program of urban real estate investment on the West Coast.

The Double Bottom Line proposes that the State provide initial funding of $5 million for matching grants to localities and non-profit organizations to fund market research which can lead to capital investment in at-risk communities. Matching funds could come from local governments, educational institutions, the private sector, and foundations. The commitment of such resources represents a highly cost efficient way to leverage and induce significant capital investment.

This pilot program would be structured to assure that the market research meets the needs of the community and the requirements of the capital sources whom it is intended to enlighten. In this regard, any state program must actively involve private sector partners to assure effective program implementation. In addition, the program must be focused on work products designed to achieve specific investment results — such as information required by potential investors in a targeted investment fund or market data needed to attract retailers and employers in a distressed community.

■ Private Sector and Foundation Capital Must Join in Partnership with the Public Sector in a New Commitment to Investing in California's Struggling Communities.

The magnitude of the challenges facing California require the full engagement of the State's civic and business leadership. This means that private sector and foundation capital must join in a commitment to "double bottom line" investing which creates economic dynamism for the State's future and broadened opportunity in California's emerging markets.

California's private sector investment leaders have demonstrated, time and time again, their extraordinary ability to create wealth and economic success for the State. The talents which have produced the strongest economy in the world must be enlisted in helping to assure continued economic success in the 21st Century. Foundations across this nation and in California have proven to be progressive forces in grappling with the societal challenges facing the State, including the consequences arising out of growing inequality of economic opportunity. The impact and contributions of the non-profit foundation sector can be amplified by new investment partnerships with public and private capital sources.

Just as the assets and investment capital of the public sector should be responsibly employed to broaden economic opportunity, so should the capital of California's foundations and private sector. The public, civic, and private sectors all bear a responsibility to be prudent stewards of California's economic future. And all share the opportunity to create economic growth and productivity in a way that secures that future.

The public policies articulated in *The Double Bottom Line* need the commitment of private sector and foundation capital to be fully realized. Clearly, no coherent investment strategy can reach fruition without the active participation of the private capital markets. Nor can any investment strategy achieve full potential without calling on the substantial assets controlled by non-profit foundations. Public programs providing financial assistance for business, community, and economic development must be married with well-priced equity and debt. Public pension fund investments must be matched with private capital partners.

This is not to say that capital investment, in and of itself, is the sole means by which California's private realm and foundation sector can contribute to the broadening of economic opportunity. Private sector enterprises can build strong business to business relationships which enhance the capacity and markets of companies located in struggling communities and employing residents of at-risk communities. They can locate new facilities in neighborhoods lacking job opportunities — locales often imbued with strategic value — and make concerted efforts to train and employ the residents of those neighborhoods so eagerly seeking upward mobility. And, along with foundations, they can focus corporate philanthropy on building the capacity of communities to fully participate in the potential of California's booming economy.

California's private sector investment leaders have demonstrated, time and time again, their extraordinary ability to create wealth and economic success for the State. The talents which have produced the strongest economy in the world must be enlisted in helping to assure continued economic success in the 21st Century.

Yet, commitment of private sector and foundation capital in a new investment dynamic is critical in its own right because of the powerful role of capital investment in economic expansion, just as public investment policy is an essential element of any concerted public sector effort to close the economic chasm.

The broader engagement of the capital markets and foundations is more critical today than ever before, not only because of the depth of the challenge of economic disparity faced by California but also because of the rapidly evolving contour of the State's financial markets. Just as an example, while the CRA has had a significant and positive impact on capital availability in California's at-risk communities, changes in the financial marketplace are resulting in limits on its impact. The last several years have seen a wave of mergers and acquisitions in the financial sector that has dramatically reduced the number of large home state lending institutions. And, banks and thrifts, to which CRA obligations apply, represented only 23 percent of the financial services markets as of 1997, down from 51 percent in 1950.[63]

The dispersion of lending and investment capital across a broad band — from insurance companies to investment banks to venture capitalists to high wealth individuals — represents both a challenge and an opportunity in creating a new investment dynamic which moves capital to communities in economic need. The challenge is to mobilize diverse interests around a common goal critical to the future of all. The opportunity lies in the very fact that the diversity of investment capital sources is a reflection of the unprecedented creation of wealth which has occurred in California throughout this last decade.

Indicative of the opportunities is the increasing wealth represented by America's grantmaking foundations. Nationally, the assets of foundations reached $385 billion in 1998, with the number of grantmaking foundations rising from just over 22,000 in 1980 to nearly 47,000 by 1998. Those foundations contributed over $22 billion to non-profit organizations in 1999 — up 42 percent from 1997 levels — and these numbers do not even speak to the untapped investment potential of this sector.[64]

A commitment by private capital to seek out and invest in ventures that offer strong returns for investors and for California makes good, long-term business sense. As the recent report, *New Markets: The Untapped Retail Buying Power in America's Inner Cities*, observed, "If America is to sustain its strong economy, we must tap new markets, drawing on unmet consumer demand, harnessing underutilized labor, and investing in developable urban land. There is a simple reality: the economy needs new room to grow — new markets where business capital can be invested to generate significant return and produce jobs and lasting community benefits."[65] And as Chairman Greenspan remarked in making the case for broader capital market investment in minority-owned businesses, "It is important to understand that failure to recognize the profitable opportunities represented by minority enterprises not only harms these firms, it harms the lending institutions and ultimately robs the broader economy of growth potential."[66]

The risks of not pursuing new paths of investment policy will be an uncertain economic future, accompanied by economic and social divisions unlikely to produce good results. The returns of investing prudently to close the gap between the "two Californias" will be an economy of sustained strength and a social fabric bound together in common purpose.

The principles that underlie the CRA should be embraced by private investment capital sources and foundations. By seeking out new markets, new investment frontiers will be discovered and new doors to economic opportunity will be opened.

The ways in which private investment capital and foundation investments can promote "double bottom line" investment policies and results are many.

Private sector and foundation capital sources can actively participate in public programs which foster community, business, and housing lending in struggling communities. The opportunities to partner — with the State of California, with entities such as Freddie Mac and Fannie Mae, with local redevelopment agencies, with community based organizations — in financially prudent community reinvestment ventures are myriad.

They can join with public pension funds and public investment pools, as partners in investment vehicles — from equity to debt — which meet appropriate risk and return criteria and which create needed real estate development and business expansion in at-risk communities. In the same way that private sector underwriting of transactions is important to public fund investment, the thorough due diligence performed by sophisticated public investment entities can provide private and foundation investors with a critical level of comfort.

And just as public funds can enrich their possibilities for returns through a new openness to domestic emerging market investment, private sector and foundation capital sources can discover new arenas of successful investment by seeking out talent of diversity knowledgeable about the opportunities in California's emerging markets, and by undertaking tailored market analyses that will allow them to fully understand the opportunities for successful investment in those markets.

In this new period of investment opportunity, foundations have a special role to play. Beyond thoughtfully investing their endowments in ways that meet the dual goals of return and reinvestment, they can be pivotal partners in community reinvestment ventures. For example, they can help fund the essential front end costs of real estate and business ventures — from market research to business formation — that can leverage substantial public and private investment funds. They also can provide needed gap financing — from "soft second" loans for home purchase by low and moderate income homeowners to "patient equity" for land assembly — which allows investments to reach deeper into communities of need. And, they can provide the funding and technical assistance which help community based business enterprises build the capacity for financial success and sustained economic returns.

For the private and foundation sectors to be most effective as partners in this new era of investment, they must reach out and build strong and sustained relationships with the communities in which they seek to invest — both to gain the knowledge that will enhance the probabilities of success and to connect communities with available capital resources.

There should be no doubt that the capital markets can find ways to successfully invest in California's emerging markets if the commitment to do so is present. After all, in an economy in which American capital invests in vehicles as diverse as foreign emerging market stocks to securitized credit card portfolios, the capability certainly exists to find smart ways to channel capital to enrich California's social and economic fabric.

The full engagement of private sector and foundation capital in pursuing the policies of *The Double Bottom Line* holds out great possibilities. The *risks* of not pursuing new paths of investment policy will be an uncertain economic future, accompanied by economic and social divisions unlikely to produce good results. The *returns* of investing prudently to close the gap between the "two Californias" will be an economy of sustained strength and a social fabric bound together in common purpose. ■

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The Double Bottom Line: Model Investment Programs for a New Era of Investment in California Communities

The Double Bottom Line: Investing in California's Emerging Markets is more than a report and more than a statement of policies. It contains specific investment initiatives which serve as models for implementation of the policies articulated in the report. These initiatives represent a beginning — a foundation on which to build. They are not meant to be all encompassing, but rather reflect initiatives the Treasurer's Office is pursuing to establish a new policy direction. The policies contained in *The Double Bottom Line* should be applied to the broad range of State programs, assets, and investments.

The programs are in various stages — from proposals to programs just under way. They are varied but they have in common a commitment to the "double bottom line" — the financially prudent management of capital and the creation of hope and opportunity in California's struggling communities.

These model initiatives will direct over $8 billion in investment capital — through State programs and the State's pension and investment funds — to spur economic growth and development in California's emerging markets. This commitment of capital is more than a one-time infusion — rather, it represents an investment pool which can be reinvested as transactions are completed and returns are realized. The initiatives also will leverage substantial, additional private investment in the sectors and communities most in need of capital for economic expansion.

Public Pension Funds and Investment Pools Can Lead the Way in a New Era of "Double Bottom Line" Investment — Achieving Successful Investment Results and Broadening Economic Opportunity.

Establish An Allocation Goal of at Least $5 Billion for Investments in California's Emerging Markets. CalPERS and CalSTRS currently establish percentage allocations, to guide investment of funds, among various asset types — such as real estate, private equity, and fixed income. In addition, the funds establish targets and goals for specific investment strategies within those asset classes.

CalPERS and CalSTRS should establish goals for investment in California's underserved markets, consistent with the funds' risk and return criteria. Those goals would represent program objectives, with attainment dependent on transactions which meet appropriate underwriting standards.

The establishment of goals would provide the forum for the funds to focus on investment opportunities in California's underserved markets which offer risk adjusted, market returns. Further, such goals would help diversify the portfolios by including investments in currently underrepresented California markets.

CalPERS and CalSTRS should set an initial goal to invest at least 2 percent of their portfolios — over $5 billion — in California emerging market opportunities, with the objective of reaching that goal by December 2002. Investments could be in a range of asset classes — from private equity to real estate to fixed income — and could include a variety of specific approaches such as the purchase of securitized California small business or affordable housing loans or investment in private equity partnerships targeted to business growth opportunities. This initial goal is a reasonable first step given the market breadth of the California nation-state and given the over $5 billion currently invested in foreign emerging markets.

$1 Billion in Home Loans for Low and Moderate Income Californians. The Pooled Money Investment Account (PMIA), chaired by the State Treasurer, will purchase $1 billion in home loans made to low and moderate income Californians or in low and moderate income neighborhoods. The first $400 million home loan purchase took place in 1999, and represents the State's first-ever purchase of community reinvestment loans with income limits and neighborhood targeting.

The purchase of Community Reinvestment Act (CRA) loans provides original lenders with new capital to make additional loans to low and moderate income homeowners and to stabilize lower income neighborhoods through homeownership. At the same time, the purchase provides the State with returns that are competitive with the overall PMIA yield. Freddie Mac stands behind the securities purchased to date.

$1 Billion in New State Deposits in California Financial Institutions. The Treasurer's Office has dramatically increased State deposits in California lending institutions — with the goal of adding at least $1 billion in deposits beyond the levels of the previous administration. This program assures a yield to the State that is above the Treasury Bill rate, with full collateral, at the same time that it provides well-priced capital to California lenders for home and business lending.

As of April 2000, this initiative has resulted in increased deposits of over $1.3 billion, with the number of institutions with which the State places deposits increasing from 35 as of December 1998 to 73. Participating institutions range from Broadway Federal serving South Los Angeles to Union Safe Deposit Bank in Stockton.

Over $1 Billion in New Investments in Urban Communities. CalPERS and CalSTRS, within the last year, have allocated over $1 billion in new investment for urban, in-fill real estate development — from mixed use to office to commercial to housing — targeted to the urban cores and underserved communities of California and the West Coast. These new investment programs are designed to achieve risk-adjusted, market returns.

Specifically, CalSTRS has allocated $750 million to a new urban investment program, enabling it to joint venture in urban real estate and to participate (up to 25 percent) with other investors in urban investment funds. In addition, CalPERS has committed $350 million to Northern and Southern California in-fill investment programs, a community reinvestment lending fund, and a venture targeted at rehabilitating and developing retail centers in underserved communities.

Securitized Small Business Loans. The PMIA will purchase $25 million annually in California-only securitized small business loans with an emphasis on purchasing loans that have been made in areas of the State that continue to struggle economically. These securities will have a higher yield than the overall PMIA yield and also will carry a federal guarantee. Special effort will be made to purchase newer loans (less than one year old) to encourage a continuous stream of capital that encourages small business lending in these areas.

Securitization both stimulates a market for this type of lending and allows institutions to make new loans as existing ones are sold in the secondary market.

CalSTRS has allocated $750 million to a new urban investment program, enabling it to joint venture in urban real estate and to participate (up to 25 percent) with other investors in urban investment funds.

Equity Investment in Business Enterprises in Communities of Economic Need. The State Treasurer proposes that CalPERS and CalSTRS allocate up to $200 million each for programs of private equity investment, targeted to achieve risk-adjusted, market returns, in businesses locating and expanding in California's economically struggling neighborhoods. Program allocations represent targets. Hitting those targets is dependent on a transaction flow which meets the funds' return and risk and underwriting criteria. These allocations would be within the funds' overall goals for investment in California's emerging markets.

Any investments made under these programs would require appropriate co-investment and would be made through investment partnerships or via the proposed New Generation investment manager programs.

Link State and Local Government Deposits to Lender Community Reinvestment Act Performance. The State of California and local governments deposit billions of dollars and transact substantial business with financial institutions throughout the nation. Those deposits and business relationships are an important component of private sector lenders' business operations.

The State Treasurer is sponsoring legislation to link State and local government deposit policies to performance under the CRA to spur lending to California's underserved communities.

Public Pension Funds Must Broaden Their Pool of Investment Managers to Capitalize on California Emerging Market Opportunities.

New Generation Investment Manager Programs for Community Reinvestment. California public pension funds — and specifically CalPERS and CalSTRS — should establish New Generation investment manager programs in the areas of private equity and real estate community reinvestment. The programs should draw on the talents of managers reflective of the investment community's increasing diversity to strengthen current and future program performance.

At the same time that public pension funds must partner with experienced and proven investment managers in undertaking community reinvestment ventures, those funds must also seek out the future talent base of qualified, competent investment managers needed to ensure success in the years ahead. New Generation programs would establish the structures required to identify new managers most knowledgeable about domestic emerging markets and to widen the net of investment opportunities to include smaller entrepreneurial investment vehicles.

Public Financial Resources and Assets Should Leverage Capital Investment in Economically Struggling Communities.

Expanded Small Business Lending. The California Pollution Control Financing Authority (CPCFA), chaired by the Treasurer, is embarking on an expansion of its California Capital Access Program (CalCAP) small business lending program with the goal of increasing the present delivery network of nine financial institutions to a network of more than 20 institutions and achieving a loan volume of $300 million over the next three years — an increase of approximately $130 million over current lending levels. The program expansion will target small businesses in economically struggling communities.

Under the CalCAP program, every public dollar contributed leverages $23 of private lending activity.

In addition, CPCFA is exploring securitization of a package of loans made under CalCAP. The sale of a securitized loan portfolio would make new capital available for small business lending to financial institutions participating in CalCAP and also would help foster a secondary market for small business loans.

Leverage Capital Investment for Brownfields Redevelopment. Many of California's struggling communities have, within their midst, contaminated sites — brownfields — that create blight and hamper community and economic revitalization. The Treasurer is proposing that CPCFA allocate $20 million of its fund balance to establish a pilot program to leverage capital investment in the remediation and reuse of brownfields sites which have economically feasible reuse potential but which require limited public financial assistance to secure equity and debt financing. The program will target a leverage ratio of at least $20 of investment to each dollar contributed by CPCFA, with a goal of leveraging up to $400 million in new investment.

The California 21st Century Fund. The Treasurer's Office will propose legislation for the 2001 legislative session to create a State-chartered investment fund, initially capitalized with $100 million in state general funds to be matched with foundation and private funding. Fund investments will leverage capital investment for real estate ventures in California's underserved, emerging markets. The fund will provide gap financing and land bank funding for projects — from housing to mixed use to commercial — which are critical to community revitalization efforts, but which require an increment of below market financing or "patient" capital.

"Smart Growth" Grant Program to Leverage Reinvestment Capital. The State Treasurer is sponsoring legislation to authorize CPCFA to make grants to local communities to create smart growth, community revitalization programs which leverage private sector and foundation investment, as well as state and federal funding. These grants will provide communities with the capacity to access needed and available public and private capital resources.

State Office Building and Leasing Policies to Promote Community Revitalization. The State Treasurer is sponsoring legislation to adopt policies which focus state office development and leasing in existing commercial or mixed use districts, with priority given to sites in economically struggling communities and proximate to transit and affordable housing. In addition, the policies encourage mixed use developments, including housing and retail, and call for State office design and development to be compatible with neighborhoods.

Expanded Community Health Clinic Lending. The California Health Facilities Financing Authority (CHFFA), chaired by the Treasurer, currently administers a State funded, direct lending program — HELP II — which provides low interest (3 percent) loans to community health clinics serving low income communities. The CHFFA is moving forward to expand lending to those health clinics by $20 million over the next three years by leveraging state monies with foundation funds and with participation by private sector lenders. The Treasurer is sponsoring legislation to authorize CHFFA partnerships with lenders.

State Government — in Partnership with Local Governments, Educational Institutions, Foundations and the Private Sector — Should Spur Capital Investment in Historically Overlooked Communities by Funding Critically Needed Market Research.

State Matching Funds for Market Research. Information is key to unlocking the doors of capital investment. To fill the information gap which inhibits investment in California's emerging markets, the State Treasurer will propose legislation under which the State initially would provide $5 million, on a matching basis, to fund market research which will enhance the flow of capital for community reinvestment.

Funding would be made available to local governments and non-profit organizations, with the requirement that State funds be coupled with local government, educational institution, foundation or private sector funding. This pilot program would engage private sector partners and research would be performed by entities which can be relied upon by investment capital sources. Research would be tailored to achieve specific investment results — such as information required by potential investors in a community reinvestment fund or market data needed by retailers to locate in a distressed community.

> The spirit of the CRA must be imbued across the broad band of California's investment capital sources to ensure the State's economic strength in the 21st Century.

Private Sector and Foundation Capital must Join in Partnership with the Public Sector in a New Commitment to Investing in California's Struggling Communities.

The public policies articulated in *The Double Bottom Line* need the engagement of private sector and foundation capital to be fully realized. Given the magnitude of the challenges facing California, it is essential that the private capital markets and foundations join in a new commitment to investing in ways which broaden economic opportunity and which close the gap between the "two Californias." The spirit of the CRA must be imbued across the broad band of California's investment capital sources to ensure the State's economic strength in the 21st Century. ■

Appendix: The Great Divide

Not since the Roaring '20s and the Great Depression of the 1930s have Californians been separated by such wide economic disparities.[1] Despite a statewide unemployment rate that has dropped to below 5 percent — the lowest level in decades[2] — pockets of high unemployment persist, and other signs of a great divide abound.

The Golden State reflects, in the extreme, what has happened across the entire country. From the end of World War II until the mid-1970s, incomes rose steadily for Americans on all rungs of the economic ladder — faster, in fact, for those on the lower rungs. Then the gap began to widen. In 1979, the average family income in the top 5 percent of the income scale was more than 10 times that in the bottom 20 percent, nationwide. By 1999, it was 19 to one.[3]

The conventional wisdom is that we are enjoying an economic boom of historic proportions. Yet in East Palo Alto and Salinas, in Compton and Bell and Huntington Park in the Los Angeles area, in the San Joaquin Valley and in the Del Paso Heights area of Sacramento, low incomes, joblessness and underemployment are all too prevalent.

Using a four-year yardstick (1993-97), the most affluent 1 percent of California's taxpayers saw their income increase 57 percent — to an average of $845,000.[4] But the average income of the middle 20 percent of the State's taxpayers — $24,177 — grew by only 1.8 percent during the same four years.[5]

A study by the Center on Budget and Policy Priorities showed that — during the decade of the 1990s — the poorest 20 percent of Californians suffered an income drop of 10 percent, to just over $12,000.[6]

Approximately 7.3 million California residents had no health insurance in 1999 — about 17 percent of the total number of uninsured in the entire country.[7] Six million of the uninsured were working people and their families.[8] Forty percent of Latinos, 23 percent of African Americans and 22 percent of Asian-Pacific Islanders were uninsured in 1999 compared to 15 percent of Caucasians in California.[9]

These disparities are reflected in many other ways, perhaps most clearly by the differences in California's communities. An economic mosaic of the state would display the vibrant colors of prosperous neighborhoods and thriving commercial and industrial areas. But the mosaic — in every region — would be dotted with the duller hues of struggling businesses, brownfields and deteriorating streets and roads.

In Los Angeles County, the hub of Southern California's regional economy, industries as diverse as computers and entertainment are creating and sustaining wealth of enormous proportions. But a United Way study revealed that although 34 percent of Los Angeles County households boast a net worth of $100,000 and above in 1998, the middle class is shrinking.[10] Almost half of Los Angeles County households had an estimated net worth of less than $25,000.[11] The high cost of living and rent in Southern California is making it increasingly difficult for many persons, ranging from teachers to office assistants to those who work in the service economy — cooks, janitors, gardeners, store clerks and nannies, for example — to survive.

Countywide in 1999, more than 20 percent of the residents were living below the official poverty line — $16,450 for a family of four.[12] And there are great economic contrasts from area to area. The effective buying power per capita in Simi Valley is more than twice that in Compton.[13]

The Great Central Valley is home to some of the nation's most technologically advanced and lucrative farm operations. But tucked off the main roads near some of the large farms are villages of tarpaper shacks and plywood shanties without toilets or running water. They are the homes of the farm workers.

Along a 180-mile stretch from Kern County to Merced County, one of every three children live below the poverty line.[14] Unemployment in the Valley averaged 11.6 percent last year, five percentage points higher than in West Virginia, the state with the nation's worst unemployment.[15] The Fresno Unified School District serves 79,000 students who are the sixth-poorest school district population in the U.S., with only school districts in cities such as East St. Louis, Ill., and Detroit ranking lower.[16] During the last decade, household income in the Central Valley has averaged 20 percent lower than household income statewide.[17]

Looking forward, job growth in the Central Valley is not expected to keep pace with population growth. The job growth rate over the next 10 years will average just 1.6 percent annually, while the population will increase 2.2 percent, according to a forecast by the UCLA Anderson School.[18]

In the Silicon Valley, arguably the densest concentration of investment capital in the world sits along a two-mile stretch of Sand Hill Road between Menlo Park and the hills above Stanford University. Newly-minted millionaires are created each day in the entrepreneurial wave that is leading the global economy. In February 2000 the median price of a single-family house in Santa Clara County was $439,000, indicative of the region's surging economy.[19]

Yet across the Bay Area those without the education and training to participate in high-tech enterprises find themselves locked into permanent renter status, minimum wage service jobs, and lack any realistic hope of improving their economic status. A 1998 study by the Urban Habitat Program showed wide economic disparities between the inner cities and older suburbs of the Bay Area and the thriving new communities on the fringe.[20]

"Ask most economists about the forces that might ultimately undo the longest expansion in U.S. history, and they'll talk about inflation, interest-rate moves by the Federal Reserve, or a plunging stock market," writes James Lardner in *U.S. News & World Report*. "The gap in wealth and income is rarely mentioned. That, an increasing number of observers contend, could be a big mistake."[21]

In California, the great economic divide is reflected, not only by the disparities in income, net worth, unemployment and the percentage of uninsured, but also by *where* people live. Our land use policies and practices, and our economic and growth patterns demonstrate how the Golden State is rapidly separating by race, by income and by class, into "two Californias."

This separation is reflected in many ways. For example, in Los Angeles County, more than 60 per cent of the residents in areas of low job growth are Latino and African American, but in areas of high job growth these groups comprise only 35 percent of the population.[22] As another example, employment growth in the suburbs is outpacing job creation in older urban and inner ring suburban areas. According to a November 1999 report by John Brennan and Edward W. Hill for The Brookings Institution, San Diego's suburban job growth rate between 1993 and 1996 was 9.5 percent, while growth in the central city was only 5.2 percent.[23] Employment in the core area of Riverside during the same three-year period dropped by 1.2 percent while growing in the suburbs by 10.1 percent — an 11.3 percent difference.[24] And in the Central Valley, Modesto's inner city employment declined by 2.5 percent while increasing by 3.9 percent in the suburbs.[25]

The cost of separation already is threatening to have profound effects on the State's economy. Suburban dwellers who historically have felt that they were insulated from the problems of the inner cities and struggling neighborhoods are now finding that their economic futures are inextricably linked to the future of the State's poorest residents. As neighborhoods are left behind while metropolitan growth races outward, the economy of both the inner cities *and* the suburbs suffers.

"By the late 1980s, across a very wide range of metro regions," report Daniel D. Luria and Joel Rogers in *Metro Futures: Economic Solutions for Cities and Their Suburbs,* "every $1,000 gained or lost in per capita city income was associated with a corresponding $690 gain or loss in per capita suburban income. Rotting central cities mean a poorer suburban future."[26]

Without addressing the issue in the obvious terms of millions of personal and family struggles, Luria and Rogers explain how human neglect translates into lost tax revenues that have a broad economic impact:

> Consider also the economic costs of human neglect. In strictly economic terms, abandoning our central cities means forsaking the productive potential of their inhabitants while paying heavily to contain their resentment, as ballooning budgets for new prisons and police make evident. And the "opportunity costs" of all that unrealized productivity are enormous. Forget about the loss of potential Nobel Prize winners. Simply subtract the average lifetime earnings of a person without decent health-care, education or job access from the lifetime earnings of someone who enjoys these basic goods. Multiply by 70 million, or even by only 20 million. It's a big number — in the trillions — which translates into a lot of foregone tax revenue for the general population.[27]

Discussing the consequences of urban growth patterns in the December 1999 edition of the *Atlantic Monthly,* Jennifer Bradley and Bruce Katz wrote:

> Much of the unhappiness of the cities is also the unhappiness of the suburbs. The familiar image of a beleaguered urban core surrounded by suburban prosperity is giving way to something more realistic and powerful: metropolitan areas in which urban *and* (emphasis added) suburban communities lose out as a result of voracious growth in undeveloped areas and slower growth or absolute decline in older places.[28]

However, despite their economic difficulties, California's urban core communities and inner-ring suburbs have assets that are frequently overlooked. Their struggles mask a wealth of human capital. Often they are strategically located near major business centers, transportation hubs and communication nodes.

Glenn Yago, writing in *Metro Futures*, observed that "…cities and neighborhoods like South Central Los Angeles remain largely untapped and ignored both as production bases and as potential markets, despite the structural conditions of the economy that could enable their recovery."[29]

For example, despite a sharp decline of the manufacturing base in South Los Angeles in the 1970s and '80s, *"Rebuilding LA's Urban Communities: A Final Report from RLA"* pointed out that many vibrant industries are located in the area. And, contrary to the commonly held perception that joblessness and welfare dependency are dominant, many residents of South Los Angeles hold full-time or nearly full-time jobs.[30] There is a high degree of labor force participation in the growing ranks of Latino immigrants in the area. Moreover, the high population density in South Los Angeles comprises a significantly large consumer base with substantial purchasing power.

Addressing the need for metropolitan reconstruction, Luria and Rogers wrote that the "Iron Law of Urban Decay is an artifact of political choice, not nature."[31] That observation also applies to struggling communities in the Central Valley and other rural areas.

California faces clear choices. Will we choose *inaction* that preserves the great economic divide, or *actions* that will lead us toward the goals of equality of opportunity and economic prosperity for all Californians? ■

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[24] Ibid.

[25] Ibid.

[26] Luria, Daniel D. and Joel Rogers, *Metro Futures: Economic Solutions for Cities and Their Suburbs*, pp. 10, 11.

[27] Ibid, p. 10.

[28] Bradley, Jennifer and Bruce Katz, "Divided We Sprawl," *The Atlantic Monthly,* December 1999.

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[31] Luria, Daniel D. and Joel Rogers, *Metro Futures: Economic Solutions for Cities and Their Suburbs*, p. 6.